DEPARTMENT OF THE TREASURY
Office of the Comptroller of the Currency
12 CFR Part 30
[Docket No. ID OCC-2019-0013]

FEDERAL RESERVE SYSTEM
12 CFR Part 208
[Docket No. OP-1680]

FEDERAL DEPOSIT INSURANCE CORPORATION
12 CFR Part 364
RIN 3064-ZA10

NATIONAL CREDIT UNION ADMINISTRATION
12 CFR Part 741
RIN 3133-AF05

Interagency Policy Statement on Allowances for Credit Losses

AGENCY: Office of the Comptroller of the Currency (OCC), Treasury; Board of Governors of the Federal Reserve System (Board); Federal Deposit Insurance Corporation (FDIC); and National Credit Union Administration (NCUA).

ACTION: Final interagency policy statement.

SUMMARY: The Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the National Credit Union Administration (collectively, the agencies) are issuing an interagency policy statement on allowances for credit losses (ACLs). The agencies are issuing this interagency policy statement in response to changes to U.S. generally accepted accounting principles (GAAP) as promulgated by the Financial Accounting Standards

Board (FASB) in Accounting Standards Update (ASU) 2016-13, *Financial Instruments – Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments* and subsequent amendments issued since June 2016. These updates are codified in Accounting Standards Codification (ASC) Topic 326, *Financial Instruments – Credit Losses* (FASB ASC Topic 326).

This interagency policy statement describes the measurement of expected credit losses under the current expected credit losses (CECL) methodology and the accounting for impairment on available-for-sale debt securities in accordance with FASB ASC Topic 326; the design, documentation, and validation of expected credit loss estimation processes, including the internal controls over these processes; the maintenance of appropriate ACLs; the responsibilities of boards of directors and management; and examiner reviews of ACLs.

DATES: The interagency policy statement is available on [INSERT DATE OF PUBLICATION IN THE **FEDERAL REGISTER**].

FOR FURTHER INFORMATION CONTACT:

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SUPPLEMENTARY INFORMATION:

I. Introduction

On October 17, 2019, the agencies requested comment for 60 days on a proposed Interagency Policy Statement on Allowances for Credit Losses[1] (proposed Policy Statement), which would maintain conformance with GAAP and FASB ASC Topic 326.

[1] 84 FR 55510 (October 17, 2019).

FASB ASC Topic 326 replaces the incurred loss methodology for financial assets measured at amortized cost, net investments in leases, and certain off-balance-sheet credit exposures, and modifies the accounting for impairment on available-for-sale debt securities. FASB ASC Topic 326 applies to all banks, savings associations, credit unions, and financial institution holding companies (collectively, institutions), regardless of size, that file regulatory reports for which the reporting requirements conform to GAAP.[2] The agencies are maintaining conformance with GAAP and consistency with FASB ASC Topic 326 through the issuance of the final Interagency Policy Statement on Allowances for Credit Losses (final Policy Statement).[3]

The agencies have issued guidelines establishing standards for safety and soundness, including operational and managerial standards that address such matters as internal controls and information systems, an internal audit system, loan documentation, credit underwriting, asset quality, and earnings that should be appropriate for an

[2] *See* section 37(a) of the Federal Deposit Insurance Act and section 202(a) of the Federal Credit Union Act. Under these statutory provisions, the accounting principles applicable to reports or statements required to be filed by all insured depository institutions with the federal banking agencies (OCC, Board, FDIC) or by all federally insured credit unions with assets of $10 million or more with the NCUA Board must be uniform and consistent with GAAP. Furthermore, regardless of asset size, all federally insured credit unions must comply with GAAP for certain financial reporting requirements relating to charges for loan losses. *See* 12 U.S.C. 1831n(a)(2)(A), 12 U.S.C. 1782(a)(6)(C), and 12 CFR 702.402(d).

[3] If the agencies determine that a particular accounting principle within GAAP, including a private company accounting alternative, is inconsistent with the statutorily specified supervisory objectives, those agencies may prescribe an accounting principle for regulatory reporting purposes that is no less stringent than GAAP. In such a situation, an institution would not be permitted to use that particular private company accounting alternative or other accounting principle within GAAP for regulatory reporting purposes.

institution's size, complexity, and risk profile.[4] The principles described in the final Policy Statement are consistent with these guidelines.

The final Policy Statement does not prescribe requirements for estimating expected credit losses. It describes the measurement of expected credit losses in accordance with FASB ASC Topic 326; the design, documentation, and validation of expected credit loss estimation processes, including the internal controls over these processes; the maintenance of appropriate ACLs; the responsibilities of boards of directors and management; and examiner reviews of ACLs.

The comment period for the proposed Policy Statement ended on December 16, 2019. The agencies received 23 comment letters from trade associations, financial institutions, and individuals. Several commenters raised issues outside of the scope of the proposed Policy Statement that were not addressed in the final Policy Statement.[5] General comments on the notice and agency responses are summarized in Section II. Specific comments on the proposed Policy Statement and changes to the final Policy Statement the agencies made in response to these comments are described in Section III.

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[4] *See* Appendix A to 12 CFR part 30 (OCC), Appendix D to 12 CFR part 208 (Board), and Appendix A to 12 CFR part 364 (FDIC), which were adopted by the banking agencies for depository institutions pursuant to section 39 of the Federal Deposit Insurance Act. *See* 12 U.S.C. 1831p-1. Federally insured credit unions should refer to section 206(b)(1) of the Federal Credit Union Act (12 U.S.C. 1786) and 12 CFR 741.3.

[5] For example, the agencies received comments requesting exemptions from applying FASB ASC Topic 326. Other commenters requested adjustments to regulatory capital requirements upon adoption of FASB ASC Topic 326.

The Paperwork Reduction Act is addressed in Section IV. Section V presents the final Policy Statement.

The final Policy Statement becomes applicable to an institution upon that institution's adoption of FASB ASC Topic 326.[6] The following policy statements are no longer effective for an institution upon its adoption of FASB ASC Topic 326: the December 2006 Interagency Policy Statement on the Allowance for Loan and Lease Losses;[7] the July 2001 Policy Statement on Allowance for Loan and Lease Losses Methodologies and Documentation for Banks and Savings Institutions;[8] and the NCUA's May 2002 Interpretive Ruling and Policy Statement 02-3, Allowance for Loan and Lease Losses Methodologies and Documentation for Federally Insured Credit Unions[9] (collectively, ALLL Policy Statements). The agencies will rescind the ALLL Policy Statements once FASB ASC Topic 326 is effective for all institutions.

II. General Comments on the Proposed Policy Statement

[6] As noted in ASU 2019-10, FASB ASC Topic 326 is effective for fiscal years beginning after December 15, 2019, including interim periods within those fiscal years, for public business entities that meet the definition of a Securities Exchange Commission (SEC) filer, excluding entities eligible to be small reporting companies as defined by the SEC. FASB ASC Topic 326 is effective for all other entities for fiscal years beginning after December 15, 2022, including interim periods within those fiscal years. For all entities, early application of FASB ASC Topic 326 is permitted as set forth in ASU 2016-13.

[7] *See* Financial Institution Letter (FIL) 105-2006 (FDIC); Supervision and Regulation (SR) Letter 06-17 (FRB); Accounting Bulletin 06-01 (NCUA); and Bulletin 2006-47 (OCC). The final Policy Statement does not affect Attachment 1 to the December 2006 Interagency Policy Statement on the Allowance for Loan and Lease Losses. Attachment 1 has been revised through a separate interagency notice published in today's **Federal Register**.

[8] *See* FIL-63-2001 (FDIC); SR 01-17 (FRB); and Bulletin 2001-37 (OCC).

[9] *See* Interpretive Ruling Policy Statement (IRPS) 02-3.

Many commenters expressed support for the proposed Policy Statement. These commenters noted that the proposal is generally consistent with FASB ASC Topic 326 and retains the flexibility and judgmental nature of GAAP. Commenters also stated that supervisory practices and principles were clearly communicated. Some commenters appreciated the agencies' statement that examiners generally should accept an institution's ACL estimates and not seek adjustments to the ACLs when management has provided adequate support for the loss estimation process employed, and the ACL balances and the assumptions used in the ACL estimates are in accordance with GAAP and regulatory reporting requirements.

A number of commenters requested that the agencies include information in the final Policy Statement to provide additional guidance around technical aspects of FASB ASC Topic 326 and reduce the amount of management judgment required to implement the accounting standard. For example, commenters requested additional clarity on segmentation, data availability, estimating expected losses for credit cards, and accounting for loans transferred between held-for-sale and held-for investment classifications.

Requests were also made for the agencies to require certain measurement approaches or methods in places where FASB ASC Topic 326 provides flexibility, such as requiring a single expected credit loss estimation method, defining the reasonable and supportable forecast period, providing an economic forecast or a simple model that can be used by all institutions, and aligning the agencies' long-standing practice for collateral-dependent loans with the collateral-dependent practical expedient in FASB ASC Topic 326.[10]

The agencies considered these requests and decided not to limit flexibility in implementing FASB ASC Topic 326 by narrowing options or defining terms that are not defined in GAAP. The final Policy Statement does not endorse a specific loss estimation method or provide more detail about specific implementation choices, including providing templates for certain methods. FASB ASC Topic 326 allows management to exercise judgment to best reflect its estimate of expected credit losses given the institution's own unique set of facts and circumstances. Specific assumptions and determinations appropriate for one institution may not be appropriate for all other institutions. The final Policy Statement recognizes that different approaches and assumptions may be used by management in estimating expected credit losses. Prescribing only one method for use in estimating expected credit losses or narrowly defining terms or concepts introduced in ASC Topic 326 in the final Policy Statement could narrow the flexibility and scalability provided in FASB ASC Topic 326.

While outside of the scope of the final Policy Statement, institutions interested in more detailed implementation examples may continue to refer to the examples included in FASB ASC Topic 326 as well as FASB Staff Q&A – Topic 326, No. 1, "Whether the Weighted-Average Remaining Maturity Method is an Acceptable Method to Estimate

[10] The regulatory reporting requirement to apply the collateral-dependent practical expedient in ASC 326-20-35-5 for collateral-dependent loans, regardless of whether foreclosure is probable, was retained by the agencies to achieve safety and soundness objectives.

Credit Losses"[11] and FASB Staff Q&A – Topic 326, No. 2, "Developing an Estimate of Expected Credit Losses on Financial Assets."[12] Institutions may also refer to training events such as the interagency webinars the agencies conducted during 2018 and 2019. These webinars reviewed acceptable loss estimation methods including the open pool loss rate method, vintage method for closed pools, weighted average remaining maturity (WARM) method, and the probability of default (PD)/loss given default (LGD) method. The agencies encourage institution management to discuss FASB ASC Topic 326 and any related questions or concerns with its board of directors, audit committee, industry peers, external auditors, and primary federal regulator.[13]

Commenters expressed concern about the level of documentation needed to support the assumptions and judgments included in an institution's estimate of expected credit losses. It is consistent with safe and sound banking practices to maintain documentation that is appropriate for an institution's size as well as the nature, scope, and risk of its activities and include clear explanations of the supporting analysis and rationale used in estimating expected credit losses under FASB ASC Topic 326. A third party that is independent of the ACL processes, whether internal or external, should also be able to understand the methodology used to determine estimated credit losses through review of the institution's ACL documentation.

[11] *See* https://www.fasb.org/jsp/FASB/Document_C/DocumentPage&cid=1176171932989.

[12] *See* https://www.fasb.org/jsp/FASB/Document_C/DocumentPage&cid=1176172970152.

[13] Some commenters noted that different messages may be provided by various parties interested in FASB ASC Topic 326. The agencies meet regularly with many of these parties, including external auditors, the FASB, the SEC, the Public Company Accounting Oversight Board (PCAOB), and industry trade associations, to discuss FASB ASC Topic 326 to promote consistency in messaging regarding implementation of the accounting standard.

The final Policy Statement is one of many steps the agencies have undertaken in assisting institutions with implementing FASB ASC Topic 326. The agencies will continue to monitor implementation activities through routine supervisory activities and will determine if any additional materials or outreach may be needed. The agencies recognize that FASB ASC Topic 326 may present implementation challenges, particularly for small community institutions and credit unions. The agencies may individually issue additional information to provide clarification beyond what is presented in the final Policy Statement as deemed necessary.

III. Specific Comments on the Proposed Policy Statement

A. Technical Revisions to the Final Policy Statement

Qualitative Factor Adjustments for Debt Securities

The proposed Policy Statement included a list of qualitative factor adjustments that may be considered when estimating expected credit losses for debt securities. Two commenters asked the agencies to clarify whether qualitative factor adjustments should also be considered for available-for-sale debt securities.

Expected credit losses for available-for-sale debt securities are measured using a discounted cash flow method. When estimating expected cash flows, institutions should consider past events, current conditions, and reasonable and supportable forecasts. While the qualitative factors included in the proposed Policy Statement may affect the institution's cash flow expectations used in the discounted cash flow calculation, the agencies have no expectation for institutions to develop and apply a separate qualitative analysis outside of the discounted cash flow model.

Consistent with FASB ASC Topic 326, qualitative factor adjustments should be considered and applied, as needed, to held-to-maturity debt securities. The final Policy Statement has been revised to indicate that the list of qualitative factor adjustments that may be considered for debt securities are specific to held-to-maturity debt securities.

Purchased Credit-Deteriorated (PCD) Assets

The proposed Policy Statement states that the non-credit discount associated with PCD assets and recorded at the time of acquisition should be accreted into interest income over the remaining life of the PCD assets on a level-yield basis. One commenter noted that the proposed Policy Statement does not specify whether the accretion of the non-credit discount should continue if the PCD asset is placed on nonaccrual status.

The determination of nonaccrual status for regulatory reporting purposes is outside of the scope of the final Policy Statement and institutions should continue to refer to existing regulatory reporting instructions[14] for information on reporting nonaccrual PCD assets. The Federal Financial Institutions Examination Council (FFIEC) will consider whether clarifications or amendments to the regulatory reporting instructions are necessary. There were no changes made to the final Policy Statement for this topic.

[14] Institutions required to file the Consolidated Reports of Condition and Income (Call Report) should refer to instruction pages RC-N-2 and RC-N-3. Institutions required to file the Consolidated Financial Statements of Holding Companies (FR Y-9C) should refer to instruction page HC-N-2. Credit unions required to file the NCUA Call Report Form 5300 should refer to the instructions for Schedule A – Specialized Lending.

Accrued Interest Receivable

The proposed Policy Statement describes the independent accounting policy elections related to estimating expected credit losses for accrued interest receivable. It further states that these accounting policy elections are made upon adoption of FASB ASC Topic 326 and may differ by financial asset portfolio.

One commenter noted that FASB ASC Topic 326 allows accounting policy elections for accrued interest receivable to be made by class of financing receivable or major security-type level, and the proposed Policy Statement could limit the use of these accounting policy elections by requiring elections by portfolio.

The agencies did not intend to limit or restrict the use of accounting policy elections related to accrued interest receivable. The final Policy Statement has been revised to align the terminology with FASB ASC Topic 326. Accounting policy elections related to accrued interest receivable may be made by class of financing receivable or major security-type.

Estimated Credit Losses for Off-Balance-Sheet Credit Exposures

The proposed Policy Statement explained that expected credit losses for off-balance-sheet financial assets are estimated using the same methods applied to similar on-balance-sheet financial assets. The estimate of expected credit losses is recorded as a liability, separate from the ACLs, because cash has not yet been disbursed to fund the contractual obligation to extend credit. The proposed Policy Statement further explained that the amount needed to adjust the liability for expected credit losses for off-balance-sheet credit exposures is reported as an other noninterest expense, consistent with current regulatory reporting instructions for the Consolidated Reports of Condition and Income.

Four commenters noted that FASB ASC Topic 326 requires the amount needed to adjust the liability for expected credit losses for off-balance-sheet credit exposures to be reported as part of credit loss expense. Commenters interpreted that this amount should be included in the provision for credit losses (PCL) rather than other noninterest expense for financial reporting purposes.

In response to the commenters' recommendation, the FFIEC will reconsider whether to modify the instructions for the Consolidated Reports of Condition and Income. The NCUA Call Report Form 5300 currently requires that the expense needed to adjust the liability for expected credit losses for off-balance-sheet credit exposures should be reported as a separate provision expense in the income statement. Additionally, the final Policy Statement has been revised to eliminate any reference to the income statement category in which amounts needed to adjust the liability for expected credit losses for off-balance-sheet credit exposures should be reported in the agencies' regulatory reports.

B. Estimating Credit Losses with Limited Loss History or Limited Losses

Some commenters requested that the final Policy Statement provide further guidance on how to estimate expected credit losses when there is limited loss history or limited losses. When an institution has a long history of data with limited credit losses, management is not expected to default to external or peer data to determine expected credit losses. Existing data should be evaluated to determine if adjustments are needed to reflect changes in items such as the nature of the assets or underwriting terms. When an institution has loss data covering only recent periods, historical loss information should be supplemented with external or peer data, industry data, or qualitative factor adjustments to ensure that expected credit losses are appropriately captured.

Management should evaluate the facts and circumstances unique to the institution's financial asset portfolios to determine the appropriate course of action with respect to data needs. The final Policy Statement provides sufficient flexibility with respect to management's evaluation of data needs and was not modified in response to these concerns.

C. Comparing Actual Credit Losses to Estimated Credit Losses

Three commenters were concerned about the agencies' suggestion in the proposed Policy Statement to evaluate the ACLs by comparing actual credit losses to estimated credit losses. As noted by one of these commenters, actual charge-off experience will not agree to the quarterly estimate of expected credit losses under FASB ASC Topic 326. Additionally, one commenter stated that this analysis could not be relied upon without looking at other metrics.

The agencies are not requiring institutions to compare actual credit losses to estimated credit losses because there are limitations in making such a comparison. Although not required, the agencies consider this comparison useful in analyzing and evaluating the ACLs. The comparison can assist in evaluating the appropriateness of the ACLs each quarter and by informing management about the reasonableness of judgments applicable to future periods. This comparison is only one point of information available. Other methods, such as ratio analysis,[15] may also provide useful information in analyzing the ACLs. Management may also develop other methods, metrics, or tools not described in the final Policy Statement to assist in the evaluation and analysis of the institution's ACLs.

The agencies are retaining the suggestion to compare actual credit losses to estimated credit losses in the final Policy Statement.

D. Responsibilities of the Board of Directors

Several commenters stated that the responsibilities of the board of directors included in the proposed Policy Statement should be simplified. One of these commenters stated that the responsibilities should be specifically defined.

The agencies intend for the board of directors' responsibilities to be appropriate for the institution's size, complexity, and risk profile. Given the judgmental nature of the ACL methods under FASB ASC Topic 326, it is important to allow each institution's board of directors to identify new activities that the board may use to oversee management's activities. The proposed Policy Statement may also include oversight activities that are not applicable to certain institutions. To provide flexibility for each institution and its individual circumstances, which may change over time, the agencies

[15] As noted in the final Policy Statement, management may also use peer comparisons to gain insight into its own ACL estimates. Management should apply caution when performing peer comparisons as there may be significant differences among peer institutions in the mix of financial asset portfolios, reasonable and supportable forecast period assumptions, reversion techniques, the data used for historical loss information and other factors.

have not made any changes to the responsibilities of the board of directors in the final Policy Statement.

E. Reliance on External Auditor to Perform Management Validation of ACLs

Commenters asked that the final Policy Statement clearly allow institutions to rely on external audit firms to perform management's validation of ACLs to minimize additional expense. External auditors are subject to applicable auditor independence standards.[16] The external auditor's performance of management's responsibilities may impair the external auditor's independence under those standards if the external auditor also performs an independent audit of the institution's financial statements. The final Policy Statement explains that a party independent of the ACL processes should validate the ACLs. An independent party may be from an internal audit function, a risk management unit of the institution, or a contracted third party.

The agencies added language to the final Policy Statement to clarify that external auditor independence may be impaired if the external auditor performs validation activities for management when the external auditor also conducts the institution's independent financial statement audit.

[16] For example, external auditors are subject to the annual audit and reporting requirements in 12 CFR part 363 that apply to certain FDIC-insured institutions. 12 CFR 363.3(f) states that "the independent public accountant must comply with the independence standards and interpretations of the AICPA, the SEC, and the PCAOB. To the extent that any of the rules within any of these standards (AICPA, SEC, and PCAOB) is more or less restrictive than the corresponding rule in the other independence standards, the independent accountant must comply with the more restrictive rule." 12 CFR 715.5 provides requirements for annual audits for federally insured credit unions and also describes auditor independence requirements for state licensed auditors.

F. Comments Specific to Credit Unions

Several credit unions commented on the proposed Policy Statement and emphasized that FASB ASC Topic 326 should not apply to credit unions. Many of these commenters requested that credit unions be exempted from FASB ASC Topic 326. These exemptions are outside of the scope of the final Policy Statement and will be addressed in other communications by the NCUA, if necessary.

At least three commenters requested that the NCUA consider and evaluate the impact FASB ASC Topic 326 will have on credit union capital levels. Although the final Policy Statement does not address capital requirements, the NCUA is considering a rulemaking that will address the potential impact to regulatory net worth.[17]

IV. Paperwork Reduction Act

In accordance with the requirements of the Paperwork Reduction Act of 1995 (PRA),[18] the agencies may not conduct or sponsor, and the respondent is not required to respond to, an information collection unless it displays a currently valid Office of Management and Budget (OMB) control number.

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[17] In late 2019, NCUA Board Chairman Rodney Hood confirmed that the NCUA has the authority to phase in a "day one" adjustment to net worth that results from the implementation of FASB ASC Topic 326.

[18] 44 U.S.C. §§ 3501-3521.

The final Policy Statement does not create any new or revise any existing collections of information under the PRA. Therefore, no information collection request will be submitted to the OMB for review.

V. Final Interagency Policy Statement on Allowances for Credit Losses

The text of the final interagency Policy Statement is as follows:

Interagency Policy Statement on Allowances for Credit Losses

Purpose

The Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System (FRB), the Federal Deposit Insurance Corporation (FDIC), and the National Credit Union Administration (NCUA) (collectively, the agencies) are issuing this Interagency Policy Statement on Allowances for Credit Losses (hereafter, the policy statement) to promote consistency in the interpretation and application of Financial Accounting Standards Board (FASB) Accounting Standards Update 2016-13, *Financial Instruments – Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*, as well as the amendments issued since June 2016.[1] These updates are codified in Accounting Standards Codification (ASC) Topic 326, *Financial Instruments – Credit Losses* (FASB ASC Topic 326). FASB ASC Topic 326 applies to

[1] The FASB issued Accounting Standards Update (ASU) 2016-13 on June 16, 2016. The following updates were published after the issuance of ASU 2016-13: ASU 2018-19 – *Codification Improvements to Topic 326, Financial Instruments—Credit Losses;* ASU 2019-04 – *Codification Improvements to Topic 326, Financial Instruments—Credit Losses, Topic 815, Derivatives and Hedging, and Topic 825, Financial Instruments;* ASU 2019-05 – *Financial Instruments – Credit Losses (Topic 326): Targeted Transition Relief;* ASU 2019-10 – *Financial Instruments—Credit Losses (Topic 326), Derivatives and Hedging (Topic 815), and Leases (Topic 842): Effective Dates*; and ASU 2019-11 – *Codification Improvements to Topic 326, Financial Instruments—Credit Losses.* Additionally, institutions may refer to FASB Staff Q&A-Topic 326, No. 1, *Whether the Weighted-Average Remaining Maturity Method is an Acceptable Method to Estimate Expected Credit Losses*, and FASB Staff Q&A-Topic 326, No. 2, *Developing an Estimate of Expected Credit Losses on Financial Assets.*

all banks, savings associations, credit unions, and financial institution holding companies (collectively, institutions), regardless of size, that file regulatory reports for which the reporting requirements conform to U.S. generally accepted accounting principles (GAAP).[2] This policy statement describes the measurement of expected credit losses in accordance with FASB ASC Topic 326; the design, documentation, and validation of expected credit loss estimation processes, including the internal controls over these processes; the maintenance of appropriate allowances for credit losses (ACLs); the responsibilities of boards of directors and management; and examiner reviews of ACLs.

This policy statement is effective at the time of each institution's adoption of FASB ASC Topic 326.[3] The following policy statements are no longer effective for an institution upon its adoption of FASB ASC Topic 326: the December 2006 Interagency Policy Statement on the Allowance for Loan and Lease Losses; the July 2001 Policy Statement on Allowance for Loan and Lease Losses Methodologies and Documentation for Banks and Savings Institutions; and the NCUA's May 2002 Interpretive Ruling and

[2] U.S. branches and agencies of foreign banking organizations may choose to, but are not required to, maintain ACLs on a branch or agency level. These institutions should refer to the instructions for the FFIEC 002, *Report of Assets and Liabilities of U. S. Branches and Agencies of Foreign Banks;* Supervision and Regulation (SR) Letter 95-4, *Allowance for Loan and Lease Losses for U. S. Branches and Agencies of Foreign Banking Organizations;* and SR Letter 95-42, *Allowance for Loan and Lease Losses for U.S. Branches and Agencies of Foreign Banking Organizations*.

[3] As noted in Accounting Standards Update 2019-10, FASB ASC Topic 326 is effective for fiscal years beginning after December 15, 2019, including interim periods within those fiscal years, for public business entities that meet the definition of a Securities Exchange Commission (SEC) filer, excluding entities eligible to be small reporting companies as defined by the SEC. FASB ASC Topic 326 is effective for all other entities for fiscal years beginning after December 15, 2022, including interim periods within those fiscal years. For all entities, early application of FASB ASC Topic 326 is permitted as set forth in ASU 2016-13.

Policy Statement 02-3, Allowance for Loan and Lease Losses Methodologies and Documentation for Federally Insured Credit Unions (collectively, ALLL Policy Statements). After FASB ASC Topic 326 is effective for all institutions, the agencies will rescind the ALLL Policy Statements.

The principles described in this policy statement are consistent with GAAP, applicable regulatory reporting requirements,[4] safe and sound banking practices, and the agencies' codified guidelines establishing standards for safety and soundness.[5] The operational and managerial standards included in those guidelines, which address such matters as internal controls and information systems, an internal audit system, loan documentation, credit underwriting, asset quality, and earnings, should be appropriate for an institution's size and the nature, scope, and risk of its activities.

Scope

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[4] For FDIC-insured depository institutions, section 37(a) of the Federal Deposit Insurance Act (12 U.SC. 1831n(a)) states that, in general, the accounting principles applicable to the Consolidated Reports of Condition and Income (Call Report) "shall be uniform and consistent with generally accepted accounting principles." Section 202(a)(6)(C) of the Federal Credit Union Act (12 U.S.C. 1782(a)(6)(C)) establishes the same standard for federally insured credit unions with assets of $10 million or greater, providing that, in general, the "[a]ccounting principles applicable to reports or statements required to be filed with the [NCUA] Board by each insured credit union shall be uniform and consistent with generally accepted accounting principles." Furthermore, regardless of asset size, all federally insured credit unions must comply with GAAP for certain financial reporting requirements relating to charges for loan losses. *See* 12 CFR 702.402(d).

[5] FDIC-insured depository institutions should refer to the *Interagency Guidelines Establishing Standards for Safety and Soundness* adopted by their primary federal regulator pursuant to section 39 of the Federal Deposit Insurance Act (12 U.S.C. 1831p-1) as follows: For national banks and federal savings associations, Appendix A to 12 CFR part 30; for state member banks, Appendix D to 12 CFR part 208; and for state nonmember banks, state savings associations, and insured state-licensed branches of foreign banks, Appendix A to 12 CFR part 364. Federally insured credit unions should refer to section 206(b)(1) of the Federal Credit Union Act (12 U.S.C. 1786) and 12 CFR 741.3.

This policy statement describes the current expected credit losses (CECL) methodology for determining the ACLs applicable to loans held-for-investment, net investments in leases, and held-to-maturity debt securities accounted for at amortized cost.[6] It also describes the estimation of the ACL for an available-for-sale debt security in accordance with FASB ASC Subtopic 326-30. This policy statement does not address or supersede existing agency requirements or guidance regarding appropriate due diligence in connection with the purchase or sale of assets or determining whether assets are permissible to be purchased or held by institutions.[7]

The CECL methodology described in FASB ASC Topic 326 applies to financial assets measured at amortized cost, net investments in leases, and off-balance-sheet credit exposures (collectively, financial assets) including:

- Financing receivables such as loans held-for-investment;
- Overdrawn deposit accounts (i.e. overdrafts) that are reclassified as held-for-investment loans;

[6] FASB ASC Topic 326 defines the amortized cost basis as the amount at which a financing receivable or investment is originated or acquired, adjusted for applicable accrued interest, accretion, or amortization of premium, discount, and net deferred fees or costs, collection of cash, write-offs, foreign exchange, and fair value hedge accounting adjustments.

[7] *See* the final guidance attached to OCC Bulletin 2012-18, *Guidance on Due Diligence Requirements in Determining Whether Securities Are Eligible for Investment* (for national banks and federal savings associations), 12 CFR part 1, *Investment Securities* (for national banks), and 12 CFR part 160, *Lending and Investment* (for federal savings associations). Federal credit unions should refer to 12 CFR part 703, *Investment and Deposit Activities*. Federally insured, state-chartered credit unions should refer to applicable state laws and regulations, as well as 12 CFR 741.219 (“investment requirements”).

- Held-to-maturity debt securities;
- Receivables that result from revenue transactions within the scope of Topic 606 on revenue from contracts with customers and Topic 610 on other income, which applies, for example, to the sale of foreclosed real estate;
- Reinsurance recoverables that result from insurance transactions within the scope of Topic 944 on insurance;
- Receivables related to repurchase agreements and securities lending agreements within the scope of Topic 860 on transfers and servicing;
- Net investments in leases recognized by a lessor in accordance with Topic 842 on leases; and
- Off-balance-sheet credit exposures including off-balance-sheet loan commitments, standby letters of credit, financial guarantees not accounted for as insurance, and other similar instruments except for those within the scope of Topic 815 on derivatives and hedging.

The CECL methodology does not apply to the following financial assets:

- Financial assets measured at fair value through net income, including those assets for which the fair value option has been elected;
- Available-for-sale debt securities;[8]
- Loans held-for-sale;

[8] Refer to FASB ASC Subtopic 326-30, Financial Instruments – Credit Losses – Available-for-Sale Debt Securities (FASB ASC Subtopic 326-30).

- Policy loan receivables of an insurance entity;
- Loans and receivables between entities under common control; and
- Receivables arising from operating leases.

Measurement of ACLs for Loans, Leases, Held-to-Maturity Debt Securities, and Off-Balance-Sheet Credit Exposures

Overview of ACLs

An ACL is a valuation account that is deducted from, or added to, the amortized cost basis of financial assets to present the net amount expected to be collected over the contractual term[9] of the assets. In estimating the net amount expected to be collected, management should consider the effects of past events, current conditions, and reasonable and supportable forecasts on the collectibility of the institution's financial assets.[10] FASB ASC Topic 326 requires management to use relevant forward-looking information and expectations drawn from reasonable and supportable forecasts when estimating expected credit losses.

[9] Consistent with FASB ASC Topic 326, an institution's determination of the contractual term should reflect the financial asset's contractual life adjusted for prepayments, renewal and extension options that are not unconditionally cancellable by the institution, and reasonably expected troubled debt restructurings. For more information, see the "Contractual Term of a Financial Asset" section in this policy statement.

[10] Recoveries are a component of management's estimation of the net amount expected to be collected for a financial asset. Expected recoveries of amounts previously written off or expected to be written off that are included in ACLs may not exceed the aggregate amounts previously written off or expected to be written off. In some circumstances, the ACL for a specific portfolio or loan may be negative because the amount expected to be collected, including expected recoveries, exceeds the financial asset's amortized cost basis.

ACLs are evaluated as of the end of each reporting period. The methods used to determine ACLs generally should be applied consistently over time and reflect management's current expectations of credit losses. Changes to ACLs resulting from these periodic evaluations are recorded through increases or decreases to the related provisions for credit losses (PCLs). When available information confirms that specific loans, securities, other assets, or portions thereof, are uncollectible, these amounts should be promptly written off[11] against the related ACLs.

Estimating appropriate ACLs involves a high degree of management judgment and is inherently imprecise. An institution's process for determining appropriate ACLs may result in a range of estimates for expected credit losses. An institution should support and record its best estimate within the range of expected credit losses.

<u>Collective Evaluation of Expected Losses</u>

FASB ASC Topic 326 requires expected losses to be evaluated on a collective, or pool, basis when financial assets share similar risk characteristics. Financial assets may be segmented based on one characteristic, or a combination of characteristics.

Examples of risk characteristics relevant to this evaluation include, but are not limited to:

[11] Consistent with FASB ASC Topic 326, this policy statement uses the verbs "write off" and "written off" and the noun "write-off." These terms are used interchangeably with "charge off," "charged off," and "charge-off," respectively, in the agencies' regulations, guidance, and regulatory reporting instructions.

- Internal or external credit scores or credit ratings;
- Risk ratings or classifications;
- Financial asset type;
- Collateral type;
- Size;
- Effective interest rate;
- Term;
- Geographical location;
- Industry of the borrower; and
- Vintage.

Other risk characteristics that may be relevant for segmenting held-to-maturity debt securities include issuer, maturity, coupon rate, yield, payment frequency, source of repayment, bond payment structure, and embedded options.

FASB ASC Topic 326 does not prescribe a process for segmenting financial assets for collective evaluation. Therefore, management should exercise judgment when establishing appropriate segments or pools. Management should evaluate financial asset segmentation on an ongoing basis to determine whether the financial assets in the pool continue to share similar risk characteristics. If a financial asset ceases to share risk characteristics with other assets in its segment, it should be moved to a different segment with assets sharing similar risk characteristics if such a segment exists.

If a financial asset does not share similar risk characteristics with other assets, expected credit losses for that asset should be evaluated individually. Individually evaluated assets should not be included in a collective assessment of expected credit losses.

Estimation Methods for Expected Credit Losses

FASB ASC Topic 326 does not require the use of a specific loss estimation method for purposes of determining ACLs. Various methods may be used to estimate the expected collectibility of financial assets, with those methods generally applied consistently over time. The same loss estimation method does not need to be applied to all financial assets. Management is not precluded from selecting a different method when it determines the method will result in a better estimate of ACLs.

Management may use a loss-rate method,[12] probability of default/loss given default (PD/LGD) method, roll-rate method, discounted cash flow method, a method that uses aging schedules, or another reasonable method to estimate expected credit losses. The selected method(s) should be appropriate for the financial assets being evaluated, consistent with the institution's size and complexity.

[12] Various loss-rate methods may be used to estimate expected credit losses under the CECL methodology. These include the weighted-average remaining maturity (WARM) method, vintage analysis, and the snapshot or open pool method.

Contractual Term of a Financial Asset

FASB ASC Topic 326 requires an institution to measure estimated expected credit losses over the contractual term of its financial assets, considering expected prepayments. Renewals, extensions, and modifications are excluded from the contractual term of a financial asset for purposes of estimating the ACL unless there is a reasonable expectation of executing a troubled debt restructuring (TDR) or the renewal and extension options are part of the original or modified contract and are not unconditionally cancellable by the institution. If such renewal or extension options are present, management must evaluate the likelihood of a borrower exercising those options when determining the contractual term.

Historical Loss Information

Historical loss information generally provides a basis for an institution's assessment of expected credit losses. Historical loss information may be based on internal information, external information, or a combination of both. Management should consider whether the historical loss information may need to be adjusted for differences in current asset specific characteristics such as differences in underwriting standards, portfolio mix, or when historical asset terms do not reflect the contractual terms of the financial assets being evaluated as of the reporting date.

Management should then consider whether further adjustments to historical loss information are needed to reflect the extent to which current conditions and reasonable and supportable forecasts differ from the conditions that existed during the historical loss period. Adjustments to historical loss information may be quantitative or qualitative in nature and should reflect changes to relevant data (such as changes in unemployment rates, delinquency, or other factors associated with the financial assets).

Reasonable and Supportable Forecasts

When estimating expected credit losses, FASB ASC Topic 326 requires management to consider forward-looking information that is both reasonable and supportable and relevant to assessing the collectibility of cash flows. Reasonable and supportable forecasts may extend over the entire contractual term of a financial asset or a period shorter than the contractual term. FASB ASC Topic 326 does not prescribe a specific method for determining reasonable and supportable forecasts nor does it include bright lines for establishing a minimum or maximum length of time for reasonable and supportable forecast period(s). Judgment is necessary in determining an appropriate period(s) for each institution. Reasonable and supportable forecasts may vary by portfolio segment or individual forecast input. These forecasts may include data from internal sources, external sources, or a combination of both. Management is not required to search for all possible information nor incur undue cost and effort to collect data for its forecasts. However, reasonably available and relevant information should not be ignored in assessing the collectibility of cash flows. Management should evaluate the appropriateness of the reasonable and supportable forecast period(s) each reporting period, consistent with other inputs used in the estimation of expected credit losses.

Institutions may develop reasonable and supportable forecasts by using one or more economic scenarios. FASB ASC Topic 326 does not require the use of multiple economic scenarios; however, institutions are not precluded from considering multiple economic scenarios when estimating expected credit losses.

Reversion

When the contractual term of a financial asset extends beyond the reasonable and supportable period, FASB ASC Topic 326 requires reverting to historical loss information, or an appropriate proxy, for those periods beyond the reasonable and supportable forecast period (often referred to as the reversion period). Management may revert to historical loss information for each individual forecast input or based on the entire estimate of loss.

FASB ASC Topic 326 does not require the application of a specific reversion technique or use of a specific reversion period. Reversion to historical loss information may be immediate, occur on a straight-line basis, or use any systematic, rational method. Management may apply different reversion techniques depending on the economic environment or the financial asset portfolio. Reversion techniques are not accounting policy elections and should be evaluated for appropriateness each reporting period, consistent with other inputs used in the estimation of expected credit losses.

FASB ASC Topic 326 does not specify the historical loss information that is used in the reversion period. This historical loss information may be based on long-term average losses or on losses that occurred during a particular historical period(s). Management may use multiple historical periods that are not sequential. Management should not adjust historical loss information for existing economic conditions or expectations of future economic conditions for periods beyond the reasonable and supportable period. However, management should consider whether the historical loss information may need to be adjusted for differences in current asset specific characteristics such as differences in underwriting standards, portfolio mix, or when historical asset terms do not reflect the contractual terms of the financial assets being evaluated as of the reporting date.

Qualitative Factor Adjustments

The estimation of ACLs should reflect consideration of all significant factors relevant to the expected collectibility of the institution's financial assets as of the reporting date. Management may begin the expected credit loss estimation process by determining its historical loss information or obtaining reliable and relevant historical loss proxy data for each segment of financial assets with similar risk characteristics.

Historical credit losses (or even recent trends in losses) generally do not, by themselves, form a sufficient basis to determine the appropriate levels for ACLs.

Management should consider the need to qualitatively adjust expected credit loss estimates for information not already captured in the loss estimation process. These qualitative factor adjustments may increase or decrease management's estimate of expected credit losses. Adjustments should not be made for information that has already been considered and included in the loss estimation process.

Management should consider the qualitative factors that are relevant to the institution as of the reporting date, which may include, but are not limited to:

- The nature and volume of the institution's financial assets;
- The existence, growth, and effect of any concentrations of credit;
- The volume and severity of past due financial assets, the volume of nonaccrual assets, and the volume and severity of adversely classified or graded assets;[13]
- The value of the underlying collateral for loans that are not collateral-dependent;[14]

[13] For banks and savings associations, adversely classified or graded loans are loans rated "substandard" (or its equivalent) or worse under the institution's loan classification system. For credit unions, adversely graded loans are loans included in the more severely graded categories under the institution's credit grading system, i.e., those loans that tend to be included in the credit union's "watch lists." Criteria related to the classification of an investment security may be found in the interagency policy statement *Uniform Agreement on the Classification and Appraisal of Securities Held by Depository Institutions* issued by the FDIC, Board, and OCC in October 2013.

[14] *See* the "Collateral-Dependent Financial Assets" section of this policy statement for more information on collateral-dependent loans.

- The institution's lending policies and procedures, including changes in underwriting standards and practices for collections, write-offs, and recoveries;
- The quality of the institution's credit review function;
- The experience, ability, and depth of the institution's lending, investment, collection, and other relevant management and staff;
- The effect of other external factors such as the regulatory, legal and technological environments; competition; and events such as natural disasters; and
- Actual and expected changes in international, national, regional, and local economic and business conditions and developments[15] in which the institution operates that affect the collectibility of financial assets.

Management may consider the following additional qualitative factors specific to held-to-maturity debt securities as of the reporting date:[16]

- The effect of recent changes in investment strategies and policies;
- The existence and effect of loss allocation methods, the definition of default, the impact of performance and market value triggers, and credit and liquidity enhancements associated with debt securities;

[15] Changes in economic and business conditions and developments included in qualitative factor adjustments are limited to those that affect the collectibility of an institution's financial assets and are relevant to the institution's financial asset portfolios. For example, an economic factor for current or forecasted unemployment at the national or state level may indicate a strong job market based on low national or state unemployment rates, but a local unemployment rate, which may be significantly higher, for example, because of the actual or forecasted loss of a major local employer may be more relevant to the collectibility of an institution's financial assets.

[16] This list is not all-inclusive, and all of the factors listed may not be relevant to all institutions.

- The effect of structural subordination and collateral deterioration on tranche performance of debt securities;
- The quality of underwriting for any collateral backing debt securities; and
- The effect of legal covenants associated with debt securities.

Changes in the level of an institution's ACLs may not always be directionally consistent with changes in the level of qualitative factor adjustments due to the incorporation of reasonable and supportable forecasts in estimating expected losses. For example, if improving credit quality trends are evident throughout an institution's portfolio in recent years, but management's evaluation of reasonable and supportable forecasts indicates expected deterioration in credit quality of the institution's financial assets during the forecast period, the ACL as a percentage of the portfolio may increase.

Collateral-Dependent Financial Assets

FASB ASC Topic 326 describes a collateral-dependent asset as a financial asset for which the repayment is expected to be provided substantially through the operation or sale of the collateral when the borrower, based on management's assessment, is experiencing financial difficulty as of the reporting date. For regulatory reporting purposes, the ACL for a collateral-dependent loan is measured using the fair value of collateral, regardless of whether foreclosure is probable.[17]

[17] The agencies, at times, prescribe specific regulatory reporting requirements that fall within a range of acceptable practice under GAAP. These specific reporting requirements, such as the requirement for institutions to apply the practical expedient in ASC 326-20-35-5 for collateral-dependent loans, regardless

When estimating the ACL for a collateral-dependent loan, FASB ASC Topic 326 requires the fair value of collateral to be adjusted to consider estimated costs to sell if repayment or satisfaction of the loan depends on the sale of the collateral. ACL adjustments for estimated costs to sell are not appropriate when the repayment of a collateral-dependent loan is expected from the operation of the collateral.

The fair value of collateral securing a collateral-dependent loan may change over time. If the fair value of the collateral as of the ACL evaluation date has decreased since the previous ACL evaluation date, the ACL should be increased to reflect the additional decrease in the fair value of the collateral. Likewise, if the fair value of the collateral has increased as of the ACL evaluation date, the increase in the fair value of the collateral is reflected through a reduction in the ACL. Any negative ACL that results is capped at the amount previously written off. Changes in the fair value of collateral described herein should be supported and documented through recent appraisals or evaluations.[18]

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of whether foreclosure is probable, have been adopted to achieve safety and soundness and other public policy objectives and to ensure comparability among institutions. The regulatory reporting requirement to apply the practical expedient for collateral-dependent financial assets is consistent with the agencies' long-standing practice for collateral-dependent loans, and it continues to be limited to collateral-dependent loans. It does not apply to other financial assets such as held-to-maturity debt securities that are collateral-dependent.

[18] For more information on regulatory expectations related to the use of appraisals and evaluations, see the *Interagency Appraisal and Evaluation Guidelines* published on December 10, 2010. Insured depository institutions should also refer to the interagency regulations on appraisals adopted by their primary federal regulator as follows: For national banks and federal savings associations, Subpart C of 12 CFR part 34; for state member banks, 12 CFR parts 208 and 225; for state nonmember banks, state savings associations, and insured state-licensed branches of foreign banks, 12 CFR part 323; and for federally insured credit unions, 12 CFR part 722.

Troubled Debt Restructurings [19]

Expected credit losses on financial assets modified in TDRs or reasonably expected to be modified in TDRs (collectively, TDRs) are estimated under the same CECL methodology that is applied to other financial assets measured at amortized cost. Expected credit losses are evaluated on a collective basis, or, if a TDR does not share similar risk characteristics with other financial assets, on an individual basis.

FASB ASC Topic 326 allows an institution to use any appropriate loss estimation method to estimate ACLs for TDRs. However, there are circumstances when specific measurement methods are required. If a TDR, or a financial asset for which a TDR is reasonably expected, is collateral-dependent, the ACL is estimated using the fair value of collateral.

In addition, when management has a reasonable expectation of executing a TDR or if a TDR has been executed, the expected effect of the modification (e.g., term extension or interest rate concession) is included in the estimate of the ACLs. Management should determine, support, and document how it identifies and estimates the effect of a reasonably expected TDR and estimates the related ACL. The estimated effect

[19] A troubled debt restructuring is defined in ASC Subtopic 310-40, Receivables – Troubled Debt Restructurings by Creditors. The October 24, 2013, Interagency Supervisory Guidance Addressing Certain Issues Related to Troubled Debt Restructurings provides more information on TDRs including, but not limited to, accrual status, regulatory credit risk grade, classification and write-off treatment, and capitalized costs. This interagency supervisory guidance remains applicable, unless affected by FASB ASC Topic 326. Information on the reporting of a subsequent restructuring of a TDR may be found in the instructions for the Call Report.

of reasonably expected TDRs may be included in an institution's qualitative factor adjustments.

Purchased Credit-Deteriorated Assets

FASB ASC Topic 326 introduces the concept of purchased credit-deteriorated (PCD) assets. PCD assets are acquired financial assets that, at acquisition, have experienced more-than-insignificant deterioration in credit quality since origination. FASB ASC Topic 326 does not provide a prescriptive definition of more-than-insignificant credit deterioration. The acquiring institution's management should establish and document a reasonable process to consistently determine what constitutes a more-than-insignificant deterioration in credit quality.

When recording the acquisition of PCD assets, the amount of expected credit losses as of the acquisition date is added to the purchase price of the financial assets rather than recording these losses through PCLs. This establishes the amortized cost basis of the PCD assets. Any difference between the unpaid principal balance of the PCD assets and the amortized cost basis of the assets as of the acquisition date is the non-credit discount or premium. The initial ACL and non-credit discount or premium determined on a collective basis at the acquisition date are allocated to the individual PCD assets.

After acquisition, ACLs for PCD assets should be adjusted at each reporting date with a corresponding debit or credit to the PCLs to reflect management's current estimate of expected credit losses. The non-credit discount recorded at acquisition will be accreted into interest income over the remaining life of the PCD assets on a level-yield basis.

Financial Assets with Collateral Maintenance Agreements

Institutions may have financial assets that are secured by collateral (such as debt securities) and are subject to collateral maintenance agreements requiring the borrower to continuously replenish the amount of collateral securing the asset. If the fair value of the collateral declines, the borrower is required to provide additional collateral as specified by the agreement.

FASB ASC Topic 326 includes a practical expedient for financial assets with collateral maintenance agreements where the borrower is required to provide collateral greater than or equal to the amortized cost basis of the asset and is expected to continuously replenish the collateral. In those cases, management may elect the collateral maintenance practical expedient and measure expected credit losses for these qualifying assets based on the fair value of the collateral.[20] If the fair value of the collateral is greater than the amortized cost basis of the financial asset and management expects the borrower to replenish collateral as needed, management may record an ACL of zero for

[20] For example, an institution enters into a reverse repurchase agreement with a collateral maintenance agreement. Management may not need to record the expected credit losses at each reporting date as long as the fair value of the security collateral is greater than the amortized cost basis of the reverse repurchase agreement. Refer to ASC 326-20-55-46 for more information.

the financial asset when the collateral maintenance practical expedient is applied. Similarly, if the fair value of the collateral is less than the amortized cost basis of the financial asset and management expects the borrower to replenish collateral as needed, the ACL is limited to the difference between the fair value of the collateral and the amortized cost basis of the asset as of the reporting date when applying the collateral maintenance practical expedient.

Accrued Interest Receivable

FASB ASC Topic 326 includes accrued interest receivable in the amortized cost basis of a financial asset. As a result, accrued interest receivable is included in the amounts for which ACLs are estimated. Generally, any accrued interest receivable that is not collectible is written off against the related ACL.

FASB ASC Topic 326 permits a series of independent accounting policy elections related to accrued interest receivable that alter the accounting treatment described in the preceding paragraph. These elections are made upon adoption of FASB ASC Topic 326 and may differ by class of financing receivable or major security-type level. The available accounting policy elections[21] are:

[21] The accounting policy elections related to accrued interest receivable that are described in this paragraph also apply to accrued interest receivable for an available-for-sale debt security that, for purposes of identifying and measuring an impairment, exclude the applicable accrued interest from both the fair value and amortized cost basis of the securities.

- Management may elect not to measure ACLs for accrued interest receivable if uncollectible accrued interest is written off in a timely manner. Management should define and document its definition of a timely write-off.
- Management may elect to write off accrued interest receivable by either reversing interest income, recognizing the loss through PCLs, or through a combination of both methods.
- Management may elect to separately present accrued interest receivable from the associated financial asset in its regulatory reports and financial statements, if applicable. The accrued interest receivable is presented net of ACLs (if any).

Financial Assets with Zero Credit Loss Expectations

There may be certain financial assets for which the expectation of credit loss is zero after evaluating historical loss information, making necessary adjustments for current conditions and reasonable and supportable forecasts, and considering any collateral or guarantee arrangements that are not free-standing contracts. Factors to consider when evaluating whether expectations of zero credit loss are appropriate may include, but are not limited to:

- A long history of zero credit loss;
- A financial asset that is fully secured by cash or cash equivalents;

- High credit ratings from rating agencies with no expected future downgrade;[22]
- Principal and interest payments that are guaranteed by the U.S. government;
- The issuer, guarantor, or sponsor can print its own currency and the currency is held by other central banks as reserve currency; and
- The interest rate on the security is recognized as a risk-free rate.

A loan that is fully secured by cash or cash equivalents, such as certificates of deposit issued by the lending institution, would likely have zero credit loss expectations. Similarly, the guaranteed portion of a U.S. Small Business Administration (SBA) loan or security purchased on the secondary market through the SBA's fiscal and transfer agent would likely have zero credit loss expectations if these financial assets are unconditionally guaranteed by the U.S. government. Examples of held-to-maturity debt securities that may result in expectations of zero credit loss include U.S. Treasury securities as well as mortgage-backed securities issued and guaranteed by the Government National Mortgage Association, the Federal Home Loan Mortgage Corporation, and the Federal National Mortgage Association. Assumptions related to zero credit loss expectations should be included in the institution's ACL documentation.

<u>Estimated Credit Losses for Off-Balance-Sheet Credit Exposures</u>

[22] Management should not rely solely on credit rating agencies but should also make its own assessment based on third party research, default statistics, and other data that may indicate a decline in credit rating.

FASB ASC Topic 326 requires that an institution estimate expected credit losses for off-balance-sheet credit exposures within the scope of FASB ASC Topic 326 over the contractual period during which the institution is exposed to credit risk. The estimate of expected credit losses should take into consideration the likelihood that funding will occur as well as the amount expected to be funded over the estimated remaining contractual term of the off-balance-sheet credit exposures. Management should not record an estimate of expected credit losses for off-balance-sheet exposures that are unconditionally cancellable by the issuer.

Management must evaluate expected credit losses for off-balance-sheet credit exposures as of each reporting date. While the process for estimating expected credit losses for these exposures is similar to the one used for on-balance-sheet financial assets, these estimated credit losses are not recorded as part of the ACLs because cash has not yet been disbursed to fund the contractual obligation to extend credit. Instead, these loss estimates are recorded as a liability, separate and distinct from the ACLs.[23] The amount needed to adjust the liability for expected credit losses for off-balance-sheet credit exposures as of each reporting date is reported in net income.

Measurement of the ACL for Available-for-Sale Debt Securities

[23] The ACL associated with off-balance-sheet credit exposures is included in the "Allowance for credit losses on off-balance-sheet credit exposures" in *Schedule RC-G – Other Liabilities* in the Call Report and in the *Liabilities* schedule in NCUA Call Report Form 5300.

FASB ASC Subtopic 326-30, *Financial Instruments – Credit Losses – Available-for-Sale Debt Securities* (FASB ASC Subtopic 326-30) describes the accounting for expected credit losses associated with available-for-sale debt securities. Credit losses for available-for-sale debt securities are evaluated as of each reporting date when the fair value is less than amortized cost. FASB ASC Subtopic 326-30 requires credit losses to be calculated individually, rather than collectively, using a discounted cash flow method, through which management compares the present value of expected cash flows with the amortized cost basis of the security. An ACL is established, with a charge to the PCL, to reflect the credit loss component of the decline in fair value below amortized cost. If the fair value of the security increases over time, any ACL that has not been written off may be reversed through a credit to the PCL. The ACL for an available-for-sale debt security is limited by the amount that the fair value is less than the amortized cost, which is referred to as the fair value floor.

If management intends to sell an available-for-sale debt security or will more likely than not be required to sell the security before recovery of the amortized cost basis, the security's ACL should be written off and the amortized cost basis of the security should be written down to its fair value at the reporting date with any incremental impairment reported in income.

A change during the reporting period in the non-credit component of any decline in fair value below amortized cost on an available-for-sale debt security is reported in other comprehensive income, net of applicable income taxes.[24]

When evaluating impairment for available-for-sale debt securities, management may evaluate the amortized cost basis including accrued interest receivable, or may evaluate the accrued interest receivable separately from the remaining amortized cost basis. If evaluated separately, accrued interest receivable is excluded from both the fair value of the available-for-sale debt security and its amortized cost basis.[25]

Documentation Standards

For financial and regulatory reporting purposes, ACLs and PCLs must be determined in accordance with GAAP. ACLs and PCLs should be well documented, with clear explanations of the supporting analyses and rationale. Sound policies, procedures, and control systems should be appropriately tailored to an institution's size and complexity, organizational structure, business environment and strategy, risk appetite, financial asset characteristics, loan administration procedures, investment

[24] Non-credit impairment on an available-for-sale debt security that is not required to be recorded through the ACL should be reported in other comprehensive income as described in ASC 326-30-35-2.

[25] The accounting policy elections described in the "Accrued Interest Receivable" section of this policy statement apply to accrued interest receivable recorded for an available-for-sale debt security if an institution excludes applicable accrued interest receivable from both the fair value and amortized cost basis of the security for purposes of identifying and measuring impairment.

strategy, and management information systems.[26] Maintaining, analyzing, supporting, and documenting appropriate ACLs and PCLs in accordance with GAAP is consistent with safe and sound banking practices.

The policies and procedures governing an institution's ACL processes and the controls over these processes should be designed, implemented, and maintained to reasonably estimate expected credit losses for financial assets and off-balance-sheet credit exposures as of the reporting date. The policies and procedures should describe management's processes for evaluating the credit quality and collectibility of financial asset portfolios, including reasonable and supportable forecasts about changes in the credit quality of these portfolios, through a disciplined and consistently applied process that results in an appropriate estimate of the ACLs. Management should review and, as needed, revise the institution's ACL policies and procedures at least annually, or more frequently if necessary.

An institution's policies and procedures for the systems, processes, and controls necessary to maintain appropriate ACLs should address, but not be limited to:

- Processes that support the determination and maintenance of appropriate levels for ACLs that are based on a comprehensive, well-documented, and consistently applied analysis of an institution's financial asset portfolios and off-balance-sheet credit exposures. The analyses and loss estimation processes used should consider

[26] Management often documents policies, procedures, and controls related to ACLs in accounting or credit risk management policies, or a combination thereof.

all significant factors that affect the credit risk and collectibility of the financial asset portfolios;

- The roles, responsibilities, and segregation of duties of the institution's senior management and other personnel who provide input into ACL processes, determine ACLs, or review ACLs. These departments and individuals may include accounting, financial reporting, treasury, investment management, lending, special asset or problem loan workout teams, retail collections and foreclosure groups, credit review, model risk management, internal audit, and others, as applicable. Individuals with responsibilities related to the estimation of ACLs should be competent and well-trained, with the ability to escalate material issues;
- Processes for determining the appropriate historical period(s) to use as the basis for estimating expected credit losses and approaches for adjusting historical credit loss information to reflect differences in asset specific characteristics, as well as current conditions and reasonable and supportable forecasts that are different from conditions existing in the historical period(s);
- Processes for determining and revising the appropriate techniques and periods to revert to historical credit loss information when the contractual term of a financial asset or off-balance-sheet credit exposure extends beyond the reasonable and supportable forecast period(s);
- Processes for segmenting financial assets for estimating expected credit losses and periodically evaluating the segments to determine whether the assets continue to share similar risk characteristics;

- Data capture and reporting systems that supply the quality and breadth of relevant and reliable information necessary, whether obtained internally or externally, to support and document the estimates of appropriate ACLs for regulatory reporting requirements and, if applicable, financial statement and disclosure requirements;
- The description of the institution's systematic and logical loss estimation process(es) for determining and consolidating expected credit losses to ensure that the ACLs are recorded in accordance with GAAP and regulatory reporting requirements. This may include, but is not limited to:
  - Management's judgments, accounting policy elections, and application of practical expedients in determining the amount of expected credit losses;
  - The process for determining when a loan is collateral-dependent;
  - The process for determining the fair value of collateral, if any, used as an input when estimating the ACL, including the basis for making any adjustments to the market value conclusion and how costs to sell, if applicable, are calculated;
  - The process for determining when a financial asset has zero credit loss expectations;
  - The process for determining expected credit losses when a financial asset has a collateral maintenance provision; and
  - A description of and support for qualitative factors that affect collectibility of financial assets;
- Procedures for validating and independently reviewing the loss estimation process as well as any changes to the process from prior periods;

- Policies and procedures for the prompt write-off of financial assets, or portions of financial assets, when available information confirms the assets to be uncollectible, consistent with regulatory reporting requirements; and
- The systems of internal controls used to confirm that the ACL processes are maintained and periodically adjusted in accordance with GAAP and interagency guidelines establishing standards for safety and soundness.

Internal control systems for the ACL estimation processes should:

- Provide reasonable assurance regarding the relevance, reliability, and integrity of data and other information used in estimating expected credit losses;
- Provide reasonable assurance of compliance with laws, regulations, and the institution's policies and procedures;
- Provide reasonable assurance that the institution's financial statements are prepared in accordance with GAAP, and the institution's regulatory reports are prepared in accordance with the applicable instructions;
- Include a well-defined and effective loan review and grading process that is consistently applied and identifies, measures, monitors, and reports asset quality problems in an accurate, sound and timely manner. The loan review process should respond to changes in internal and external factors affecting the level of credit risk in the portfolio; and
- Include a well-defined and effective process for monitoring credit quality in the debt securities portfolio.

Analyzing and Validating the Overall Measurement of ACLs

To ensure that ACLs are presented fairly, in accordance with GAAP and regulatory reporting requirements, and are transparent for regulatory examinations, management should document its measurements of the amounts of ACLs reported in regulatory reports and financial statements, if applicable, for each type of financial asset (e.g., loans, held-to-maturity debt securities, and available-for-sale debt securities) and for off-balance-sheet credit exposures. This documentation should include ACL calculations, qualitative adjustments, and any adjustments to the ACLs that are required as part of the internal review and challenge process. The board of directors, or a committee thereof, should review management's assessments of and justifications for the reported amounts of ACLs.

Various techniques are available to assist management in analyzing and evaluating the ACLs. For example, comparing estimates of expected credit losses to actual write-offs in aggregate, and by portfolio, may enable management to assess whether the institution's loss estimation process is sufficiently designed.[27] Further, comparing the estimate of ACLs to actual write-offs at the financial asset portfolio level allows management to analyze changing portfolio characteristics, such as the volume of

[27] Institutions using models in the loss estimation process may incorporate a qualitative factor adjustment in the estimate of expected credit losses to capture the variance between modeled credit loss expectations and actual historical losses when the model is still considered predictive and fit for use. Institutions should monitor this variance, as well as changes to the variance, to determine if the variance is significant or material enough to warrant further changes to the model.

assets or increases in write-off rates, which may affect future forecast adjustments. Techniques applied in these instances do not have to be complex to be effective, but, if used, should be commensurate with the institution's size and complexity.

Ratio analysis may also be useful for evaluating the overall reasonableness of ACLs. Ratio analysis assists in identifying divergent or emerging trends in the relationship of ACLs to other factors such as adversely classified or graded loans, past due and nonaccrual loans, total loans, historical gross write-offs, net write-offs, and historic delinquency and default trends for securities.

Comparing the institution's ACLs to those of peer institutions may provide management with limited insight into management's own ACL estimates. Management should apply caution when performing peer comparisons as there may be significant differences among peer institutions in the mix of financial asset portfolios, reasonable and supportable forecast period assumptions, reversion techniques, the data used for historical loss information, and other factors.

When used prudently, comparisons of estimated expected losses to actual write-offs, ratio analysis, and peer comparisons can be helpful as a supplemental check on the reasonableness of management's assumptions and analyses. Because appropriate ACLs are institution-specific estimates, the use of comparisons does not eliminate the need for a comprehensive analysis of financial asset portfolios and the factors affecting their collectibility.

When an appropriate expected credit loss framework has been used to estimate expected credit losses, it is inappropriate for the board of directors or management to make further adjustments to ACLs for the sole purpose of reporting ACLs that correspond to a peer group median, a target ratio, or a budgeted amount. Additionally, neither the board of directors nor management should further adjust ACLs beyond what has been appropriately measured and documented in accordance with FASB ASC Topic 326.

After analyzing ACLs, management should periodically validate the loss estimation process, and any changes to the process, to confirm that the process remains appropriate for the institution's size, complexity, and risk profile. The validation process should include procedures for review by a party with appropriate knowledge, technical expertise, and experience who is independent of the institution's credit approval and ACL estimation processes. A party who is independent of these processes could be from internal audit staff, a risk management unit of the institution independent of management supervising these processes, or a contracted third-party. One party need not perform the entire analysis as the validation may be divided among various independent parties.[28]

Responsibilities of the Board of Directors

[28] Engaging the institution's external auditor to perform the validation process described in this paragraph when the external auditor also conducts the institution's independent financial statement audit, may impair the auditor's independence under applicable auditor independence standards and prevent the auditor from performing an independent audit of the institution's financial statements.

The board of directors, or a committee thereof, is responsible for overseeing management's significant judgments and estimates used in determining appropriate ACLs. Evidence of the board of directors' oversight activities is subject to review by examiners. These activities should include, but are not limited to:

- Retaining experienced and qualified management to oversee all ACL and PCL activities;
- Reviewing and approving the institution's written loss estimation policies, including any revisions thereto, at least annually;
- Reviewing management's assessment of the loan review system and management's conclusion and support for whether the system is sound and appropriate for the institution's size and complexity;
- Reviewing management's assessment of the effectiveness of processes and controls for monitoring the credit quality of the investment portfolio;
- Reviewing management's assessments of and justifications for the estimated amounts reported each period for the ACLs and the PCLs;
- Requiring management to periodically validate, and, when appropriate, revise loss estimation methods;
- Approving the internal and external audit plans for the ACLs, as applicable; and
- Reviewing any identified audit findings and monitoring resolution of those items.

Responsibilities of Management

Management is responsible for maintaining ACLs at appropriate levels and for documenting its analyses in accordance with the concepts and requirements set forth in GAAP, regulatory reporting requirements, and this policy statement. Management should evaluate the ACLs reported on the balance sheet as of the end of each period (and for credit unions, prior to paying dividends), and debit or credit the related PCLs to bring the ACLs to an appropriate level as of each reporting date. The determination of the amounts of the ACLs and the PCLs should be based on management's current judgments about the credit quality of the institution's financial assets and should consider known and expected relevant internal and external factors that significantly affect collectibility over reasonable and supportable forecast periods for the institution's financial assets as well as appropriate reversion techniques applied to periods beyond the reasonable and supportable forecast periods. Management's evaluations are subject to review by examiners.

In carrying out its responsibility for maintaining appropriate ACLs, management should adopt and adhere to written policies and procedures that are appropriate to the institution's size and the nature, scope, and risk of its lending and investing activities. These policies and procedures should address the processes and activities described in the "Documentation Standards" section of this policy statement.

Management fulfills other responsibilities that aid in the maintenance of appropriate ACLs. These activities include, but are not limited to:

- Establishing and maintaining appropriate governance activities for the loss estimation process(es). These activities may include reviewing and challenging the assumptions used in estimating expected credit losses and designing and executing effective internal controls over the credit loss estimation method(s);
- Periodically performing procedures that compare credit loss estimates to actual write-offs, at the portfolio level and in aggregate, to confirm that amounts recorded in the ACLs were sufficient to cover actual credit losses. This analysis supports that appropriate ACLs were recorded and provides insight into the loss estimation process's ability to estimate expected credit losses. This analysis is not intended to reflect the accuracy of management's economic forecasts;
- Periodically validating the loss estimation process(es), including changes, if any, to confirm it is appropriate for the institution; and
- Engaging in sound risk management of third parties involved[29] in ACL estimation process(es), if applicable, to ensure that the loss estimation processes are commensurate with the level of risk, the complexity of the third-party relationship and the institution's organizational structure.

Additionally, if an institution uses loss estimation models in determining expected credit losses, management should evaluate the models before they are employed and

[29] Guidance on third party service providers may be found in SR Letter 13-19/Consumer Affairs Letter 13-21, *Guidance on Managing Outsourcing Risk* (FRB); Financial Institution Letter (FIL) 44-2008, *Guidance for Managing Third Party Risk* (FDIC); Supervisory Letter No. 07-01, *Evaluating Third Party Relationships* (NCUA); and OCC Bulletin 2013-29, *Third Party Relationships: Risk Management Guidance*, OCC Bulletin 2017-7, *Third Party Relationships: Supplemental Examination Procedures*, and OCC Bulletin 2017-21, *Third Party Relationships: Frequently Asked Questions to Supplement OCC Bulletin 2013-29*.

modify the model logic and assumptions, as needed, to help ensure that the resulting loss estimates are consistent with GAAP and regulatory reporting requirements.[30] To demonstrate such consistency, management should document its evaluations and conclusions regarding the appropriateness of estimating credit losses with models. When used for multiple purposes within an institution, models should be specifically adjusted and validated for use in ACL loss estimation processes. Management should document and support any adjustments made to the models, the outputs of the models, and compensating controls applied in determining the estimated expected credit losses.

Examiner Review of ACLs

Examiners are expected to assess the appropriateness of management's loss estimation processes and the appropriateness of the institution's ACL balances as part of their supervisory activities. The review of ACLs, including the depth of the examiner's assessment, should be commensurate with the institution's size, complexity, and risk profile. As part of their supervisory activities, examiners generally assess the credit quality and credit risk of an institution's financial asset portfolios, the adequacy of the institution's credit loss estimation processes, the adequacy of supporting documentation, and the appropriateness of the reported ACLs and PCLs in the institution's regulatory reports and financial statements, if applicable. Examiners may consider the significant

[30] *See* the interagency statement titled, *Supervisory Guidance on Model Risk Management*, published by the Board in SR Letter 11-7 and OCC Bulletin 2011-12 on April 4, 2011. The statement also addresses the incorporation of vendor products into an institution's model risk management framework following the same principles relevant to in-house models. The FDIC adopted the interagency statement on June 7, 2017. Institutions supervised by the FDIC should refer to FIL-22-2017, *Adoption of Supervisory Guidance on Model Risk Management*, including the statement of applicability in the FIL.

factors that affect collectibility, including the value of collateral securing financial assets and any other repayment sources. Supervisory activities may include evaluating management's effectiveness in assessing credit risk for debt securities (both prior to purchase and on an on-going basis). In reviewing the appropriateness of an institution's ACLs, examiners may:

- Evaluate the institution's ACL policies and procedures and assess the loss estimation method(s) used to arrive at overall estimates of ACLs, including the documentation supporting the reasonableness of management's assumptions, valuations, and judgments. Supporting activities may include, but, are not limited to:
    - Evaluating whether management has appropriately considered historical loss information, current conditions, and reasonable and supportable forecasts, including significant qualitative factors that affect the collectibility of the financial asset portfolios;
    - Assessing loss estimation techniques, including loss estimation models, if applicable, as well as the incorporation of qualitative adjustments to determine whether the resulting estimates of expected credit losses are in conformity with GAAP and regulatory reporting requirements; and
    - Evaluating the adequacy of the documentation and the effectiveness of the controls used to support the measurement of the ACLs;
- Assess the effectiveness of board oversight as well as management's effectiveness in identifying, measuring, monitoring, and controlling credit risk. This may

include, but is not limited to, a review of underwriting standards and practices, portfolio composition and trends, credit risk review functions, risk rating systems, credit administration practices, investment securities management practices, and related management information systems and reports;

- Review the appropriateness and reasonableness of the overall level of the ACLs relative to the level of credit risk, the complexity of the institution's financial asset portfolios, and available information relevant to assessing collectibility, including consideration of current conditions and reasonable and supportable forecasts. Examiners may include a quantitative analysis (e.g., using management's results comparing expected write-offs to actual write-offs as well as ratio analysis) to assess the appropriateness of the ACLs. This quantitative analysis may be used to determine the reasonableness of management's assumptions, valuations, and judgments and understand variances between actual and estimated credit losses. Loss estimates that are consistently and materially over or under predicting actual losses may indicate a weakness in the loss forecasting process;
- Review the ACLs reported in the institution's regulatory reports and in any financial statements and other key financial reports to determine whether the reported amounts reconcile to the institution's estimate of the ACLs. The consolidated loss estimates determined by the institution's loss estimation method(s) should be consistent with the final ACLs reported in its regulatory reports and financial statements, if applicable;

- Verify that models used in the loss estimation process, if any, are subject to initial and ongoing validation activities. Validation activities include evaluating and concluding on the conceptual soundness of the model, including developmental evidence, performing ongoing monitoring activities, including process verification and benchmarking, and analyzing model output.[31] Examiners may review model validation findings, management's response to those findings, and applicable action plans to remediate any concerns, if applicable. Examiners may also assess the adequacy of the institution's processes to implement changes in a timely manner; and
- Review the effectiveness of the institution's third-party risk management framework associated with the estimation of ACLs, if applicable, to assess whether the processes are commensurate with the level of risk, the complexity and nature of the relationship, and the institution's organizational structure. Examiners may determine whether management monitors material risks and deficiencies in third-party relationships, and takes appropriate action as needed.[32]

When assessing the appropriateness of ACLs, examiners should recognize that the processes, loss estimation methods, and underlying assumptions an institution uses to calculate ACLs require the exercise of a substantial degree of management judgment. Even when an institution maintains sound procedures, controls, and monitoring activities, an estimate of expected credit losses is not a single precise amount and may result in a range of acceptable outcomes for these estimates. This is a result of the flexibility FASB

[31] *See* footnote 30.

[32] *See* footnote 29.

ASC Topic 326 provides institutions in selecting loss estimation methods and the wide range of qualitative and forecasting factors that are considered.

Management's ability to estimate expected credit losses should improve over the contractual term of financial assets as substantive information accumulates regarding the factors affecting repayment prospects. Examiners generally should accept an institution's ACL estimates and not seek adjustments to the ACLs, when management has provided adequate support for the loss estimation process employed, and the ACL balances and the assumptions used in the ACL estimates are in accordance with GAAP and regulatory reporting requirements. It is inappropriate for examiners to seek adjustments to ACLs for the sole purpose of achieving ACL levels that correspond to a peer group median, a target ratio, or a benchmark amount when management has used an appropriate expected credit loss framework to estimate expected credit losses.

If the examiner concludes that an institution's reported ACLs are not appropriate or determines that its ACL evaluation processes or loss estimation method(s) are otherwise deficient, these concerns should be noted in the report of examination and communicated to the board of directors and senior management.[33] Additional supervisory action may be taken based on the magnitude of the shortcomings in ACLs, including the materiality of any errors in the reported amounts of ACLs.

[33] Each agency has formal and informal communication channels for sharing supervisory information with the board of directors and management depending on agency practices and the nature of the information being shared. These channels may include, but are not limited to, institution specific supervisory letters, letters to the industry, transmittal letters, visitation findings summary letters, targeted review conclusion letters, or official examination or inspection reports.

Joseph M. Otting,
Comptroller of the Currency.

By order of the Board of Governors of the Federal Reserve System.

Ann Misback,

Secretary of the Board.

Federal Deposit Insurance Corporation.
By order of the Board of Directors.
Dated at Washington, DC, on February 20, 2020.
Robert E. Feldman,
Executive Secretary.

By the National Credit Union Administration Board.

Gerard Poliquin,
Secretary of the Board.